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UNCLAS SECTION 01 OF 06 MANILA 004528

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Sensitive

E.O. 12958: N/A
TAGS: EFIN ECON EINV PGOV RP
SUBJECT: Proposed 2006 Budget: A Taxing Proposition

Refs: A) 04 Manila 4545, B) Manila 4112

Sensitive But Unclassified

¶1. (SBU) Summary: President Arroyo's proposed 2006 budget call for a 30 percent increase in funds for infrastructure, health, and education while continuing to reduce the budget deficit for a fourth consecutive year. The 1.05-trillion peso ($18.8 billion) budget proposal represents 7.5% year-on-year growth in real terms and to 4.1% growth with respect to real per capita spending. The GRP hopes to reduce its budget deficit by 30.6% to 125 billion pesos (2.1% of GDP) this year and as it moves to eliminate the deficit by 2008. Although non-discretionary budget items (government salaries and benefits, legally-mandated transfers to local government units, and debt servicing) will consume the bulk of the proposed budget. The 2006 proposal relies heavily on more than 80 billion pesos ($1.46 billion) in incremental revenues from the legislated, but yet to be implemented, amended Expanded Value Added Tax law. With public resistance to new and higher taxes reinforced by political challenges, improvements in tax collection efficiency and anti-corruption efforts will be increasingly critical to restoring longer-term fiscal stability. End Summary.

PRESIDENT ARROYO SUBMITS 2006 BUDGET PLAN

¶2. (U) On August 24, President Gloria Macapagal-Arroyo submitted to the Philippine Congress a proposed 1.05 trillion pesos ($18.8 billion) obligation budget for the National Government for calendar year 2006, a 14.7% (134.7 billion pesos) nominal increase from 2005. The 2006 budget proposal translates to 7% growth in real terms after factoring in the Government's 7.5% inflation forecast and to 4.1% real per capita growth after factoring in the Philippines 2.4% annual population growth rate. It is more expansionary than 2005's tight budget program (Ref A), which provides for a nominal expansion of less than 6% (51.6 billion pesos) and translates to a 2% contraction after inflation and to a 4.1% decline in real per capita terms.

BATS FOR HIGHER NON-DISCRETIONARY BUT ESSENTIAL SPENDING

¶3. (U) We estimate the non-discretionary portion of the 2006 budget proposal -- i.e., the sum of government personnel expenses, legally mandated transfers to local government units (LGUs), and debt-service payments -- to expand by 11% (82.8 billion pesos) in 2006, from about 9.7% (66.5 billion pesos) in 2005, and to account for more than 60% of 2006's overall budget increase. Nearly half (41.3 billion pesos) of the envisioned year-on-year expansion for non-discretionary expenditures reflects higher outlays for personnel salaries and benefits, including a pay hike for Government workers for the first time in four years. The higher personnel budget also includes an estimated 10 billion pesos for separation/retirement benefits to fund Government efforts to rationalize the bureaucracy.

¶4. (U) An estimated 8.5% (26.6 billion pesos) increase in interest payments and 9.8% (14.9 billion pesos) expansion in legally mandated revenue transfers to LGUs would account for 29.9% and 16.7%, respectively, of the overall year-on-year increase for non-discretionary spending. (Note: Aggregate budget levels include interest payments only. Principal payments are treated as part of the financing program. From 12% in 2005, the

Government estimates total principal and interest payments to increase by a slower rate of 7.1% to 721.7 billion pesos. End Note.) Both the 2005 and 2006 budgets include 18 billion pesos in additional interest payments to service 200 billion pesos in debts assumed by the National Government from the National Power Corporation in December 2004, as provided under the Electric Power Industry Reform Act of 2001. The assumed NPC debts will also add an estimated 35 billion pesos to principal payments falling due next year.

¶5. (U) Non-discretionary budget items will still consume the bulk (about 79.5%) of the 2006 budget plan, although a somewhat smaller share than in 2005 (81.4%). However, the Government hopes that a larger budget would allow it to hike spending for non-discretionary but essential expenditure items by over 30% (52 billion pesos), following an 8.3% (14.9 billion pesos) contraction this year. This includes a planned 38% (21.8 billion pesos) expansion for infrastructure (following a 2.4% decline in 2005) and 19.7% (17 billion pesos) increase for maintenance and other operating expenses.

Proposed 2006 Obligation Budget By Type of Expense

	Billion Pesos 2005 Program	Billion Pesos 2006 Proposal	Growth (%) 2005	Growth (%) 2006	% Share 2005	% Share 2006
Total	918.6	1,053.3	6.0	14.7	100.0	100.0
Non-Discretionary Expenditures a/	754.2	837.0	9.7	11.0	82.1	79.5
Personnel	289.2	320.5	1.2	14.3	31.5	31.4
Allotment to LGUs b/	151.6	166.5	7.5	9.8	16.5	15.8
Debt Serv. c/	313.4	340.0	11.6	8.5	34.1	31.7
Discretionary Expenditures a/	164.4	216.3	-8.3	31.6	17.9	20.5
Maintenance & Operating	86.5	103.5	7.7	19.7	9.4	9.8
Support to Gov't Firms d/	11.6	14.2	-47.0	22.4	1.3	1.2
Infrastructure	57.2	79.0	-2.4	38.1	6.2	7.5

a/ Embassy estimates from available GRP statistics
b/ Internal revenue allotments mandated under the Local Government Code
c/ Interest payments; principal payments are treated as part of the financing program
d/ Subsidies, equity contributions, and net lending to government-owned and controlled corporations

Source of Basic Data: Dept. of Budget and Management

¶6. (U) Net of interest payments and revenue transfers to LGUs, a sectoral breakdown of the 2006 budget proposal envisions expenditure hikes mainly for communications, roads and transport networks; health care delivery; education and manpower development; defense and peace and order; and social security and employment (which includes the 10 billion pesos targeted next year for personnel rationalization efforts, para 3). Spending for most of these sectors either declined or barely expanded under the 2005 expenditure program.

Proposed 2006 Obligation Budget By Type of Allocation

	Billion Pesos 2005 Program	Billion Pesos 2006 Proposal	Growth (%) 2005	Growth (%) 2006	% Share 2005	% Share 2006
Total	918.6	1,053.3	6.0	14.7	100.0	100.0
Economic Serv. a/	104.9	138.9	-11.7	32.4	11.4	13.2
Agriculture & Agrarian Ref.	25.9	27.5	-9.1	6.2	2.8	2.6
Communication, Roads, Transport	53.8	71.8	-19.3	33.5	5.9	6.8
Social Serv. a/	198.2	232.3	-4.5	17.2	21.6	22.1
Education & Manpower Devt	135.4	146.4	5.1	8.1	14.7	13.9
Health	12.9	13.7	-11.0	6.2	1.4	1.3
Soc. Security & Employment	40.1	58.6	-10.5	46.1	4.4	5.6
Defense	44.2	52.4	3.5	18.6	4.8	5.0
Gen. Pub. Serv. a/	99.4	114.9	-0.4	15.6	10.8	10.9
Gen. Admin	41.3	48.4	-9.5	17.2	4.5	4.6
Public Order & Safety	54.4	60.5	2.1	11.2	5.9	5.7
Net Lending b/	6.9	8.3	21.1	20.3	0.8	0.8

Allotment to LGUs	151.6	166.5	7.5	9.8	16.5	15.8
Debt Service c/	313.4	340.0	11.6	8.5	34.1	32.3

a/ Net of legally-mandated internal revenue allotments to LGUs
b/ Net advances to government-owned or controlled firms (mainly to service loan obligations)
c/ Interest payments; principal payments are treated as part of the financing program

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Source of Basic Data: Dept. of Budget and Management

SMALLER FISCAL DEFICIT DESPITE LARGER BUDGET

¶7. (U) Despite a more expansionary budget, the National Government is targeting a fourth consecutive year of declining fiscal deficits. For 2006, the goal is to narrow the National Government's budget gap to 124.9 billion pesos (2.1% of GDP), from the 197.8-billion peso (3.4% of GDP) deficit ceiling programmed for 2005. The Government hopes to expand revenue collections by 23.7% (185.4 billion pesos) year-on-year, nearly double the 12% revenue growth rate targeted for 2005. Over 90% of the targeted revenue increase reflects a 23.8% (168.1 billion pesos) growth in tax collections. The envisioned 14.6% tax-to-GDP ratio in the 2006 fiscal program represents an improvement from 2005's 13.3% goal, although it remains short of the peak 17% tax-to-GDP ratio achieved in 1997.

National Government Fiscal Program a/

	Billion Pesos			Growth (%)	
	2004 Actual	2005 Program	2006 Proposal	2005	2006
REVENUES	699.8	783.2	968.6	11.9	23.7
Tax	598.0	706.2	874.3	18.1	23.8
As % of GDP	12.6%	13.3%	14.6%		
Nontax	101.8	77.0	94.3	-24.4	22.5
DISBURSEMENTS a/	886.8	963.2	1,093.5	8.6	13.5
SURPLUS/DEF	- 187.1	-180.0	-124.9	-3.8	-30.6
As % of GDP	-3.9%	-3.4%	-2.1%		

a/ Cash basis (disbursements therefore differ from obligation budget)

Source: Department of Finance

¶8. (U) The budget/fiscal program discussed in this cable refers to that of the National Government and focuses on a subset of the Consolidated Public Sector Deficit (CPSD). The consolidated deficit includes the finances of government corporations, social security agencies and local government units. The Government hopes to reduce the consolidated public sector deficit (CPSD) -- which peaked at 5.3% of GDP in 2003 -- from 3.4% of GDP in 2005 to 2.1% of GDP in 2006. This calls for a 29% (52.2 billion pesos) decline in the CPSD level. Narrowing the deficit of the National Government will therefore be crucial to significantly reducing the overall deficit of the consolidated public sector.

EVAT: ICING IN 2005 BUT CRITICAL IN 2006

¶9. (U) The Government did not impute incremental revenues from the amended Expanded Value Added Tax (EVAT) law in the 2005 budget. This centerpiece revenue-raising legislation was not implemented as scheduled on July 1 due to legal challenges filed before the Supreme Court. However, implementation becomes critical in 2006, with 83 billion pesos in full-year incremental revenues estimated in the 2006 fiscal program. That amount would represent about 1.4% of 2006 GDP, without which there would be no improvement in the tax-to-GDP ratio; 9.5% of total 2006 tax revenues; about half of the targeted year-on-year expansion in tax collections; and nearly 64% of the envisioned expansion in cash disbursements. With EVAT, the National Government hopes to balance the budget by 2008, two years ahead of the original target. (Note: The Philippine Supreme Court recently upheld the legality of the amended EVAT law in a decision issued on September ¶1. However, the Court has yet to lift its Temporary Restraining Order and provided a fifteen-day waiting period before the decision becomes final - Ref B. There could be further delay if petitioners file a motion for reconsideration within that fifteen-day period. End Note.)

¶10. (U) Implementing the EVAT law will also affect the Government's goal of financing a larger budget while keeping the fiscal deficit in check and tempering the pace of debt accumulation. With the amended EVAT, the National Government envisions that tax revenues will be able to finance a larger 80% share of 2006 disbursements, up from 73% during 2005. As a result, the GRP estimates that it will need to borrow 7.8% (44.5 billion pesos) less year-on-year from domestic and foreign capital markets to plug the fiscal deficit and to service principal payments on its debt obligations. It hopes to reduce the ratio of the National Government's outstanding debts to GDP to about 73% by the end of 2006 (from over 80% in 2004 and 79% in 2005) and to reduce this ratio further to under 55% by the end of 2010. As it has done in recent years, the National Government plans to tap the larger share (i.e., 60%) of its 2006 borrowing program from domestic capital markets in an effort to temper foreign exchange risks arising from the significant share (47% as of May 2005) of foreign-denominated obligations in its loan portfolio.

National Government Borrowing Program

	Billion Pesos			Growth (%)	
	2004 Actual	2005 Program	2006 Proposal	2005	2006
Borrowings	583.3	576.4	531.6	-1.2	-7.8
Domestic	383.8	348.7	310.2	-9.1	-11.0
Foreign	199.5	222.7	221.4	11.6	-0.6
US$ (Bill.)	3.6	4.0	4.0	11.1	0.0
To Finance:					
Budget Def.	187.1	180.0	124.9	-3.8	-3.6
Principal	340.8	360.7	381.7	5.8	5.8
Domestic	222.4	231.4	262.6	4.0	13.5
Foreign	118.4	129.3	119.1	9.2	-7.9
US$ (Bill.)	2.1	2.3	2.1	9.5	-8.7
Others a/	55.4	35.7	25.0	-35.6	-30.0

a/ Mostly for cash buffer

Source: Department of Budget and Management

¶11. (SBU) Implementation of the EVAT raises many important questions about future fiscal health. Increased spending on non-discretionary items will depend largely on additional revenues that the GRP expects the EVAT to generate. Estimates of 83 billion pesos from EVAT in 2006 might be overly optimistic, and the 30 percent planned increase in infrastructure, education and health care might never materialize.

¶12. (SBU) The debate continues within the GRP and in Congress over EVAT exemptions for oil and electricity, especially with prevailing high oil prices. If exemptions for these items are maintained through the first half of 2006, the GRP would have to reduce discretionary spending by 20 billion pesos ($360 million) or more in order to maintain fiscal balances.

¶13. (SBU) The GRP track record for revenue generation in the first year of new taxes has been weak. Officials had estimated that the sin taxes on alcohol and tobacco products, for example, would improve revenues by about 10 billion pesos or more in 2005, but the latest data indicate that these taxes generated no new revenues. Major producers of low-price cigarettes front-loaded production and sales prior to the imposition of these taxes and employed other non-transparent methods to circumvent the tax. Observers indicate that novel methods could be used to circumvent the EVAT, especially since the GRP has launched no new programs or countermeasures to ensure compliance.

COMMENT

¶14. (U) The Government deserves credit for progress made since 2003 to pass new tax measures (i.e., increasing excise taxes for tobacco and alcohol, institutionalizing a system of rewards and penalties in revenue collection agencies, and the amended EVAT), prevent a further deterioration in the tax-to-GDP ratio, and reduce the fiscal deficit. However, the GRP also recognizes that squeezing expenditures is not a sustainable long-term strategy and hopes to continue narrowing the deficit while spending more on vital budget items. Despite new tax measures and the more expansionary budget envisioned for next year, more resources are required for the Philippines to compete effectively with neighboring economies for investments

and capital. Neighboring countries, for example, have already been spending more heavily on infrastructure relative to the barely 1.5% to GDP ratio of the National Government and less than 2.5% to GDP ratio of the consolidated public sector.

¶15. (SBU) Resistance to new and/or higher taxes is high -- reflecting public perception of corruption, wastage, and inefficiency -- and has increased further in the midst of current economic and political challenges. Despite recent improvements, the Philippines' tax-to-GDP ratio remains among the lowest in East Asia and is likely to come under increasing public scrutiny. Sustained efforts to combat corruption and boost collection efficiency, such as those outlined in the GRP's concept paper for the Millennium Challenge Account Threshold program, will be increasingly important to GRP efforts to reduce deficits and address the debt problem while improving the delivery of vital social and economic services.

Johnson